VALE COLUMBIA CENTER
ON SUSTAINABLE INTERNATIONAL INVESTMENT
A JOINT CENTER OF COLUMBIA LAW SCHOOL AND THE EARTH INSTITUTE AT COLUMBIA UNIVERSITY

Columbia FDI Perspectives

Perspectives on topical foreign direct investment issues by the Vale Columbia Center on Sustainable International Investment

No. 75 July 30, 2012

Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)
Managing Editor: Jennifer Reimer (jreimer01@gmail.com)

Attracting FDI through BITs and RTAs: Does treaty content matter?

by
Axel Berger, Matthias Busse, Peter Nunnenkamp, and Martin Roy[*]

It may appear all too obvious that the extent to which foreign direct investment (FDI) is attracted by bilateral investment treaties (BITs) and regional trade agreements (RTAs) depends on the strength of key investment provisions. Still, BITs and RTAs have typically been treated as black boxes in prior empirical literature, ignoring two important legal innovations: investor-state dispute settlement (ISDS) and pre-establishment national treatment (NT) provisions.[1]

An assessment of the impact of different classes of BITs and RTAs on bilateral FDI flows between up to 28 home and 83 developing host countries (covering the period 1978-2004[2]) yields strong evidence that liberal admission rules promote bilateral FDI. For instance, a host country could increase its share in total FDI flows by almost 30% in the hypothetical case of switching from RTAs without pre-establishment NT provisions to RTAs with such provisions

[*] Axel Berger (axel.berger@die-gdi.de) is a researcher in the Department for World Economy and Development Finance at the German Development Institute; Matthias Busse (matthias.busse@rub.de) is Professor of International Economics and Director of the Institute of Development Research and Development Policy at the Ruhr-University of Bochum; Peter Nunnenkamp (peter.nunnenkamp@ifw-kiel.de) is Senior Fellow in the research areas "Global Division of Labor" and "Poverty Reduction, Equity, and Development" at the Kiel Institute for the World Economy; Martin Roy (Martin.Roy@wto.org) is Counsellor in the WTO Secretariat. The authors wish to thank Andrew Guzman, Lauge Poulsen and Jeswald Salacuse for their helpful peer reviews. **The views expressed by the authors of this *Perspective* do not necessarily reflect the opinions of Columbia University or its partners and supporters. Columbia FDI Perspectives (ISSN 2158-3579) is a peer-reviewed series.**

[1] Recent efforts to code BITs and RTAs help overcome this gap. Jason Yackee classified BITs according to ISDS provisions. (Jason Yackee, "Do BITs really work? Revisiting the empirical link between investment treaties and foreign direct investment," in Karl P. Sauvant and Lisa E. Sachs, eds., *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows* (Oxford: OUP, 2009), pp. 379-394.) We supplemented Yackee's work and coded BITs and RTAs with respect to NT provisions in the pre-establishment phase.(Axel Berger, Matthias Busse, Peter Nunnenkamp, and Martin Roy, "Do trade and investment agreements lead to more FDI? Accounting for key provisions inside the black box," International Economics and Economic Policy (forthcoming).) The inclusion of such provisions guarantees market access for multinational enterprises (MNEs). As regards pre-establishment NT provisions, we classified BITs and RTAs in four types: the most liberal and transparent type adopts a negative-list approach and lists existing non-conforming measures; the second adopts a negative-list approach but with less transparency regarding non-conforming measures; the third adopts a positive list approach which is limited to services sectors; and the fourth does not contain any NT provisions on pre-establishment.

[2] Ibid.

in relation to all possible partner countries. In conducting our analysis, we used a wide range of control variables, employed different estimation methods to test the robustness of our findings, and also found that the results are not due to reverse causality. Like other similar studies, however, our model did not given data limitations or account for unilateral changes in the admission of FDI. Compared to NT provisions, ISDS mechanisms appear to play a minor role.

Also in contrast to what one might expect, the impact of similar investment provisions on bilateral FDI depends on whether these provisions are contained in RTAs or BITs. RTAs offering nothing specific to foreign investors, in terms of liberal admission or effective dispute settlement, leave bilateral FDI unaffected or may even induce a substitution of home-country exports for FDI. By comparison, foreign investors respond to BITs rather indiscriminately regardless of the strength of dispute settlement or market access provisions. This may be surprising given that some recent BITs are no longer restricted to investor protection and extend to FDI liberalization. The low profile and rather technical nature of BIT negotiations provide a possible explanation; foreign investors may tend to regard BITs as agreements containing a similar set of rules, without checking their legal intricacy. Clearly, further qualitative studies are needed better to understand how investors take into account BITs and RTAs when making investment decisions.[3]

Our findings suggest that governments seeking to attract FDI may put greater emphasis on providing comprehensive and transparent admission guarantees. It is primarily the market access guarantees provided by NT at the pre-establishment phase that appears to lead to more FDI. NT provisions using negative list modalities improve legal security and predictability at the admission phase. Specifically, signalling effects appear strongest if pre-establishment NTprovisions cover all sectors, precisely list non-conforming measures and generally bind access conditions at the currently level of openness. More restrictive approaches of limiting NT provisions to selected sectors do not appear to be effective.

Concerns the choice between BITs and RTAs, policymakers seeking to attract FDI may face a dilemma. The negotiation and ratification of RTAs tend to be highly politicized. This may help alert foreign investors and increase FDI. However, rule setting in RTAs typically covers a much wider area than in BITs and could impose additional costs. Policymakers should know that RTAs tend to be ineffective in promoting FDI if the focus is exclusively on trade liberalization. On the other hand, the technical nature of BIT negotiations may have the effect that foreign investors are hardly aware of more favourable features that BITs may contain. Investment promotion agencies bear major responsibility to convince foreign investors that it is worthwhile checking the small print of BITs.

For further information please contact: Vale Columbia Center on Sustainable International Investment, Jennifer Reimer, jreimer01@gmail.com or jreimer@lyhplaw.com.

[3] Various econometric studies on the subject are not in line with recent survey evidence which suggests that MNEs rarely take BITs into account while deciding where and how much to invest. Similar discrepancies between surveys and econometric evidence exist when assessing the relative importance of cost-driven versus market-driven motives for FDI.

The Vale Columbia Center on Sustainable International Investment (VCC – www.vcc.columbia.edu), led by Lisa Sachs, is a joint center of Columbia Law School and The Earth Institute at Columbia University. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. VCC focuses on the analysis and teaching of the implications of FDI for public policy and international investment law.

Most recent Columbia FDI Perspectives

- No. 74, M Sornarajah, "Starting anew in international investment law," July 16, 2012.
- No. 73, Lorenzo Cotula, "Law at two speeds: Legal frameworks regulating foreign investment in the global South," June 29, 2012.
- No. 72, Torfinn Harding and Beata Javorcik, "Roll out the red carpet and they will come: Investment promotion and FDI inflows," June 18, 2012.
- No. 71, Thomas Jost, "Much ado about nothing? State-controlled entities and the change in German investment law," June 4, 2012.
- No. 70, Terutomo Ozawa, "FDI, catch-up growth stages and stage-focused strategies," May 28, 2012.
- No. 69, Karl P. Sauvant, "The times they are a-changin' -- again -- in the relationships between governments and multinational enterprises: From control, to liberalization to rebalancing," May 21, 2012.
- No. 68, Sophie Meunier et al., "Economic patriotism: Dealing with Chinese direct investment in the United States," May 14, 2012.
- No. 67, Paul Antony Barbour et al., "The Arab Spring: How soon will foreign investors return?," May 7, 2012.
- No. 66, Kalman Kalotay, "Does it matter who invests in your country?," April 30, 2012.
- No. 65, Mark Feldman, "The standing of state-controlled entities under the ICSID Convention: Two key considerations," April 16, 2012.